Supreme Court, U.S.
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No. _____

In The

Supreme Court of the United States

FRANKLIN P. COADY; NONA COADY,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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39 pp

QUESTION PRESENTED

The Commissioner of Internal Revenue mailed a notice of deficiency to Petitioners, determining a deficiency in federal income tax and alternative minimum tax of $49,531 for the 1994 tax year.

The lower courts upheld the Commissioner's determination. The question presented here is:

> Should legal fees paid to Coady's attorney pursuant to a contingent fee arrangement in a wrongful termination action constitute taxable income to the Coadys, such that both the attorney and client are taxable on the same income?

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PETITION FOR WRIT OF CERTIORARI

Franklin P. Coady and Nona Coady ("Coady") respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on June 14, 2000, in order to resolve the conflict between the Ninth and Sixth Circuit Courts of Appeals on the important issue presented herein.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit that gives rise to this petition is reprinted in Appendix A hereto ("App. A") at page A-1. By order filed August 25, 2000, the Ninth Circuit denied the petition for rehearing. App. A, A-13.

The memorandum opinion of the United States Tax Court is reprinted in App. A at page A-23.

JURISDICTION

On August 6, 1998 the United States Tax Court issued a memorandum decision in favor of the Commissioner of Internal Revenue ("Commissioner"). Coady timely appealed to the Ninth Circuit, which affirmed in an opinion filed on June 14, 2000. On August 25, 2000 the Ninth Circuit denied Coady's timely filed petition for rehearing. Pursuant to Supreme Court Rule 13.1, this petition has been filed within 90 days of the denial of rehearing.

The jurisdiction of the Court is invoked pursuant to 23 U.S.C. Section 1254(1).

STATUTES INVOLVED IN THIS CASE

26 U.S.C. Section 61(a)(1) (hereinafter "Internal Revenue Code") provides:

> (a) GENERAL DEFINITION. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> > (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

Internal Revenue Code Section 7701(a)(2), provides:

> (2) PARTNERSHIP AND PARTNER. The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of the title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

STATEMENT OF THE CASE

Nona Coady was a plaintiff in a wrongful termination suit brought in Alaska state court against Alaska Housing Finance Corporation ("AHFC"). The law firm of

Hellen, Partnow & Condon was retained by Coady to represent her on contingent fee basis.

The lawsuit was resolved in Coady's favor and they received $373,307 from AHFC in 1994. Coady paid legal fees of $221,338 to Hellen, Partnow & Condon in 1994 pursuant to the settlement of the AHFC civil suit.

The Commissioner determined that the attorneys' fee paid to Hellen, Partnow & Condon in settlement of the AHFC civil suit, and on which Hellen, Partnow & Condon had paid taxes, should also be taxed as income to Mrs. Coady and her husband, Franklin P. Coady.

The Tax Court adopted the Commissioner's position, in effect holding that the attorneys' fees taxed as income to Hellen, Partnow & Condon were also taxable income to the Coadys.

The Ninth Circuit affirmed, holding that the Coadys were not entitled to exclude from their gross income $168,217 for costs and contingent legal fees incurred in securing the judgment for wrongful termination.

Coady's petition for rehearing was denied.

REASONS FOR GRANTING THE WRIT

I. THE NINTH CIRCUIT'S OPINION DIRECTLY CONFLICTS WITH THE SIXTH CIRCUIT'S RULING IN *ESTATE OF CLARKS* AND MISCONSTRUES *LUCAS V. EARL* AND *HELVERING V. HORST.*

The decision below is in direct conflict with the Sixth Circuit's decision in *Estate of Clarks v. United States,* 202

F.3d 854 (6th Cir. 2000). See App. A, A-14. Certiorari is appropriate here.

The Sixth Circuit in *Estate of Clarks* held that the lawyer and client were not both taxable on the same income under Internal Revenue Code Section 61(a). The question before the court was whether interest on a personal injury judgment paid to the lawyer under a contingent fee contract must be included as gross income of client, as well as included in the lawyer's income.

The court stated that the value of the taxpayer's lawsuit was entirely speculative and dependent on the services of counsel, and that the only economic benefit Mr. Clarks could derive from his claim was to use the contingent part of it to help him collect the remainder. Thus, like an interest in partnership agreement or joint venture, Mr. Clarks contracted for services and assigned his lawyer a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds.

The court cited *Cotnam v. Commissioner*, 263 F.2d 119, (5th Cir. 1959), that correctly distinguished *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 (1940). The court rejected the government's theory that both the lawyer and the client are taxable on the same income, stating that the contingent fee transaction is more like a division of property than an assignment of income. In sharp contrast the Ninth Circuit held that both the lawyer and the client are taxable on the same income.

Coady's exclusion from gross income of the $168,217 contingent attorneys' fee would have been allowed under the Sixth Circuit's analysis in *Estate of Clarks*.

Estate of Clarks presents the better reasoned approach. While *Estate of Clarks* correctly distinguishes *Lucas v. Earl* and *Helvering v. Horst*, the decision below misconstrues those cases, thereby obligating two different taxpayers to pay tax on the same earnings, resulting in double taxation. The reasoning of the Ninth and Sixth Circuits creates conflicting results on virtually identical facts. In the instant case there was double taxation, in *Estate of Clarks* there was not. The conflict is clear and irreconcilable. Certiorari is appropriate.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS

FRANKLIN P. COADY; NONA COADY, *Petitioners-Appellants,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellee.*	No. 98-71358 Tax Ct. No. 4722-97 **OPINION**

Appeal from an Order of the
United States Tax Court
David Laro, Tax Court Judge, Presiding

Argued and Submitted
May 5, 2000 – Seattle, Washington

Filed June 14, 2000

Before: Edward Leavy, Pamela Ann Rymer, and Thomas G. Nelson, Circuit Judges.

Opinion by Judge Rymer

COUNSEL

Lance Hulbert, Bothell, Washington, for the petitioners-appellants.

David English Carmack, Karen D. Utiger (signed the brief), and Kenneth W. Rosenberg (argued), United States Department of Justice, Washington, D.C., for the respondent-appellee.

OPINION

RYMER, Circuit Judge:

The issue before us is whether Franklin and Nona Coady were entitled to exclude from their 1994 gross income $168,217 for costs and contingent legal fees incurred in securing Nona Coady's judgment for lost wages and benefits arising out of her wrongful termination. We conclude that they were not, and affirm.

I

In May 1990, Nona Coady was discharged from her position as Senior Loan Officer at Alaska Housing Finance Corporation (AHFC). Along with her husband, Coady retained the law firm of Hellen, Partnow & Condon (HPC) to represent her in a wrongful termination suit against AHFC for a contingent fee of 33.33% (45% if the judgment were appealed) or $185 per hour plus costs. After a bench trial, the court held that AHFC was liable to Coady for $373,307 ($89,225 for back pay, $76,980 for future lost earnings, and $207,102 for lost fringe and pension benefits). AHFC issued a check to Coady for $259,610.89 in full payment of the judgment (withholding $113,696.11 for federal income taxes, FICA/OASDA, and FICA/MED). The Coadys paid $221,338.32 to HPC ($124,435.67 in attorneys' fees and $96,902.65 in litigation costs).[1]

---

[1] Litigation expenses totaled $99,951.74. The Coadys had deposited $3,300 as advance payment of legal costs in 1993.

On their joint 1994 Federal Income Tax Return, the Coadys excluded $284,082 for the portion of the $373,307 award not paid on account of past wages, instead reporting it as self-employment income on Schedule C of their return. They reported as income from wages only that portion of the award that was paid for back wages ($89,225). The Coadys claimed a deduction of $168,217 for attorneys' fees and litigation costs (the amount of fees and costs proportionate to the portion of the award they reported as self-employment income). This resulted in a net income from self-employment of $115,865. The Coadys claimed a miscellaneous itemized deduction of $53,121 for attorneys' fees and litigation costs proportionate to the $89,225 of the award they reported as income from wages.

The Commissioner sent the Coadys a statutory notice of deficiency, stating that the entire $373,307 should have been included in their 1994 gross income and that the attorneys' fees and litigation costs of $221,338 were deductible as a miscellaneous itemized deduction. The Commissioner asserted a deficiency in tax of $49,531 (plus interest). The Coadys filed suit in tax court. The case was submitted on a fully stipulated record, and the Coadys conceded that the $284,082 reported on Schedule C should not have been reported as self-employment income on Schedule C but should have been reported along with the $89,225 as income from wages. The parties agreed that the $53,121 was deductible as a Schedule A "Miscellaneous Deduction." The parties disagreed as to whether the remaining legal fees and costs of $168,217 ($221,338 less $53,121) constituted reportable income.The Commissioner contended that the fees and costs were

deductible as a Schedule A "Miscellaneous Deduction." The Coadys argued that the fees and costs were not reportable income at all.[2] The tax court upheld the Commissioner's determination. The Coadys appeal.

II

The Coadys contend that they are entitled to exclude $168,217 from gross income because they "assigned" that portion of their settlement to counsel. They rely on *Cotnam v. C.I.R.*, 263 F.2d 119 (5th Cir. 1959). There, the taxpayer (Ms. Cotnam) won a contract action against the estate of T. Shannon Hunter, who had promised Cotnam one-fifth of his estate in return for her serving him as an attendant. Hunter died without a will, but Cotnam sued and was awarded $120,000, of which $50,365.83 was paid to her attorneys as a contingency fee. After Cotnam paid her taxes, exempting the award as a bequest, the Commissioner determined a deficiency in tax of $36,985.02. The Fifth Circuit Court of Appeals first reasoned that the amount Cotnam received was not exempt as a bequest but was taxable income for services rendered. *See id.* at 121. However, the panel split as to whether the fee paid to Cotnam's attorney should be included in her gross income. Judge Rives and Judge Brown concluded that the $50,365.83 paid to Cotnam's attorneys "should not be

---

[2] Pursuant to 26 U.S.C. § 67(b), all itemized deductions not falling within the enumerated list in that subsection are called "miscellaneous itemized deductions." Miscellaneous itemized deductions may be deducted from the taxpayer's income "to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." 26 U.S.C. § 67(a).

included in her gross income. This sum was income to the attorneys but not to Mrs. Cotnam." *Id.* at 125. Under Alabama law, "[a]ttorneys have the same rights as their clients." *Id.* Pursuant to 46 Code of Alabama § 64 (1940):

> Upon suits, judgments, and decrees for money, they shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said suit, judgment or decree, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them.

Cotnam "could never have received the $50,365.83, even if she had settled the case directly with the Bank." *Id.* at 125. The Alabama statute "creates a charge 'in the nature of an equitable assignment * * * (or) equitable lien' in the cause of action. An attorney 'holding such an interest has an equity in the cause of action and the recovery under it *prior* to that of the defendant in the judgment to exercise a right of set-off accruing to him after the attorney's interest had attached.' " *Id.* at 125 (quoting *United States Fidelity & Guaranty Co. v. Levy*, 77 F.2d 972, 975 (5th Cir. 1935)) (emphasis added). Accordingly, the court concluded that based on the Alabama statute, the taxpayer was "in a position where she did not realize income as to her attorneys' interests of 40% in her cause of action and judgment." *Id.* Judge Wisdom dissented, reasoning that "at the time of the assignment to the attorneys all of her services had been rendered and all of the income earned." *Id.* at 126 (Wisdom, J. dissenting).

The rule in *Cotnam* has been subject to disagreement among the circuit courts of appeals. The Sixth Circuit recently followed *Cotnam* in *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000), concluding that the interest portion of an attorney's contingency fee should not be included in the client's gross income. *See id.* at 855-56. The court reasoned that the "common law lien in this case under Michigan law operates in more or less the same way as the Alabama lien in *Cotnam*" because "[a]lthough the underlying claim for personal injury was originally owned by the client, the client lost his right to receive payment for the lawyer's portion of the judgment." *Id.* at 856. According to the *Clarks* court:

> In the instant case, as in *Cotnam*, the value of the taxpayer's lawsuit was entirely speculative and dependent on the services of counsel. The claim simply amounted to an intangible, contingent expectancy. . . . Like an interest in a partnership agreement or joint venture, Clarks contracted for services and assigned his lawyer a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds. Just as in *Cotnam*, the assignment Clarks' lawyer received operated as a lien on a portion of the judgment sought to be recovered transferring ownership of that portion of the judgment to the attorney.

Id. at 857.

However, the Federal and First Circuits have declined to follow *Cotnam*. In *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995), the Federal Circuit rejected a taxpayer's claim that because a portion of an award was paid directly to the taxpayer's attorneys, that portion was

never part of its gross income: "Very little need be said about this argument, which, if accepted, would elevate form over substance and allow the partnership [the taxpayer] to escape taxation on a portion of its income through a 'skillfully devised' fee arrangement." *Id.* at 1454 (citation omitted). *Baylin* reasoned that

> [A]lthough the partnership did not take actual possession of the funds it paid to its attorney, opting instead to pay him directly out of its eventual recovery, it is evident that the partnership received the benefit of those funds in that the funds served to discharge the obligation of the partnership owing to the attorney as a result of the attorney's efforts to increase the settlement amount. The fee arrangement signifies the value that the parties placed on the attorney's services. In other words, the partnership "made such use or disposition of [its] power to receive . . . the income as to procure in its place other satisfactions which are of economic worth." *Helvering v. Horst*, 311 U.S. 112, 116, 61 S. Ct. 144, 85 L.Ed. 75 (1940).

Id. at 1454-55 Additionally, the court stated:

> That the partnership assigned a portion of its condemnation recovery to its attorney before it knew the exact amount of the recovery does not mean that this amount never belonged to the partnership; it means simply that the attorney and client chose to estimate the value of the attorney's services by tying the fee to the ultimate recovery and by having the obligation of the client to the attorney discharged by having the state pay the attorney his fees directly from

> the recovery. The temporarily uncertain magnitude of the legal fees under such an arrangement and the vehicle of an assignment cannot dictate the income tax treatment of those fees.

Id. at 1454; *see also Alexander v. Internal Revenue Service*, 72 F.3d 938, 944-46 (1st Cir. 1995) (holding that legal fees expended in procuring a settlement for the loss of salary and retirement benefits should be included in gross income and are deductible as a miscellaneous itemized deduction).

We are persuaded by Baylin, Alexander, and Judge Wisdom's dissent in *Cotnam*. This case is unlike *Cotnam* and *Clarks* because under Alaska law, attorneys do not have a superior lien or ownership interest in the cause of action as they do in Alabama and Michigan:

> (a) An attorney has a lien for compensation, whether specially agreed upon or implied, as provided in this section
>
> > (1) first, upon the papers of the client that have come into the possession of the attorney in the course of the professional employment;
> >
> > (2) second, upon money in the possession of the attorney belonging to the client;
> >
> > (3) third, upon money in the possession of the adverse party in an action or proceeding in which the attorney is employed, from the giving of notice of the lien to that party;
> >
> > (4) fourth, upon a judgment to the extent of the costs included in the judgment or, if there is a special agreement, to the extent of the compensation specially agreed on, from

> the giving of notice of the lien to the party against whom the judgment is given and filing the original with the clerk where the judgment is entered and docketed.
>
> (b) This lien is, however, subordinate to the rights existing between the parties to the action or proceeding.

Alaska Stat. § 34.35.430. According to the statute, an attorney obtains a lien which attaches to property belonging to the client; it does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients. *See Hagans, Brown & Gibbs v. First Nat. Bank of Anchorage*, 783 P.2d 1164, 1168 (Alaska 1989).

The Coadys received full payment of the judgment from AHFC. Title 26 U.S.C. § 61(a) defines gross income very broadly as "all income from whatever source derived." "[A]ny funds or other accessions to wealth received by a taxpayer are presumed to be gross income and are includable as such in the taxpayer's return, unless the taxpayer can demonstrate that the funds or accessions fit into one of the specific exclusions created by the Code." *Getty v. C.I.R.*, 913 F.2d 1486, 1490 (9th Cir. 1990).

To determine whether an award of damages or a settlement payment constitutes gross income, we look to " 'the nature of the underlying action.' " *Id.* (quoting *Tribune Pub. Co. v. United States*, 836 F.2d 1176, 1177 (9th Cir. 1988)). We ask: "In lieu of what were the damages awarded?" *Id.* (internal quotations omitted). Here, the award was in lieu of wages and compensation, and is clearly gross income. *See Commissioner v. Schleier*, 515 U.S.

323, 328-30 (1995) (back wages received on account of wrongful termination constitute gross income); *Commissioner v. Smith*, 324 U.S. 177, 181 (1945) (any economic or financial benefit conferred on the employee as compensation constitutes gross income). The entire amount of the award was paid to Nona Coady, and therefore reportable as income. The Coadys simply used a portion of the award subsequently to discharge their personal liability to their attorneys.

The Supreme Court has explicitly rejected the notion that taxation can be escaped by procuring payment directly to creditors or by making anticipatory arrangements to prevent earnings from "vesting even for a second" in the person who earned it. *See Lucas v. Earl*, 281 U.S. 111, 114-15 (1930) ("There is no doubt that the [Revenue Act] could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it."). "[T]he rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor." *Helvering v. Horst*, 311 U.S. 112, 116 (1940). Even if the taxpayer "procures payment directly to his creditors of the items of interest or earnings, . . . he does not escape taxation because he did not actually receive the money." *Id.* (citations omitted); *see also Helvering v. Eubank*, 311 U.S. 122, 124-25 (1940); *United States v. Basye*, 410 U.S. 441, 449 (1973) ("[I]ncome must be taxed

to him who earns it. . . . The entity earning the income . . . cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person or entity.") (citations omitted); *Chugach Alaska Corp. v. United States*, 34 F.3d 1462, 1467 (9th Cir. 1994) (same).

The Coadys argue that these cases are distinguishable because here there was the existence of real doubt at the time of the assignment of the contingency fee. However, we have previously held that the fact that such an assignment involves a contingent amount does not alter the conclusion that taxation cannot be escaped by making anticipatory arrangements to prevent earnings from vesting in the person who earned it. *See Kochansky v. C.I.R.*, 92 F.3d 957, 959 (9th Cir. 1996) (portion of a contingency fee that a lawyer assigned to his ex-wife was taxable to the lawyer, not to his wife despite the fact that the fee was "uncertain, doubtful, and contingent" at the time the lawyer assigned it). So has the Federal Circuit. *See Baylin*, 43 F.3d at 1454-55. Therefore, we conclude that Coady's recovery for back pay and benefits was income to her on which she cannot avoid taxation by diversion to creditors, including counsel for a contingency fee.

III

In the alternative, the Coadys contend that their arrangement with HPC establishes a joint venture or partnership for federal tax purposes under § 7701(a)(2). However, we decline to consider this argument because

the Coadys failed to raise it in the Tax Court. *See Broad v. Sealaska Corp.*, 85 F.3d 422, 430 (9th Cir. 1996).

AFFIRMED.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

FRANKLIN P. COADY; NONA COADY, Petitioners-Appellants, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	No. 98-71358 Tax Ct. No. 4722-97 ORDER (Filed Aug. 25, 2000)

Before: LEAVY, RYMER, and T.G. NELSON, Circuit Judges.

Appellants' petition for rehearing is DENIED.

Estate of Arthur L. Clarks, by and through its duly appointed Independent Personal Representative, Mary J. Brisco-Whittier, also known as Mary J. Clarks, Plaintiff-Appellant v. United States of America, Defendant-Appellee.

U.S. Court of Appeals, 6th Circuit; 98-2437, 1/13/2000. Reversing a District Court Decision, 98-2 USTC ¶ 50,868.

[Code Secs. 61 and 104]

Who is the taxpayer: Settlement agreement: Interest: Damages: Personal injury: Attorneys' fees: Contingency fees: Gross income, exlusion: Receipt of income. – A decedent's estate that received a substantial award in a personal injury lawsuit was allowed to exclude from gross income the interest portion of its attorney's contingency fee, which was paid directly to the lawyer. Noting the existence of a conflict among the appellate circuits regarding the taxation of the interest portion of an attorney's contingency fee, the court rejected the government's theory that both the lawyer and the client were taxable on the funds. The only economic benefit that the decedent could derive from his claim against the defendant in state court was to use the contingent part of it to help him collect the remainder. The contingency fee agreement with his attorney was an assignment and, under state (Michigan) law, operated as a lien on a portion of the decedent's prospective judgment that transferred ownership of that portion of the judgment to the attorney. Furthermore, since the income was the result of the lawyer's personal skill and judgment,

it had to be charged to the party who earned and received the funds, and not to the decedent. *E.W. Cotnam* (CA-5), 59-1 USTC ¶ 9200, followed; *R.H. Lucas v. G.C. Earl* (SCt), 2 USTC ¶ 496, and *G.T. Helvering v. P.R.G. Horst* (SCt), 40-2 USTC ¶ 9787, distinguished. Back references: ¶ 2200.115, 5900.122, 5900.1241, 5900.1242 and 6662.513.

Harley D. Manela, Lakritz, Herman & Wissbrun, Bingham Farms, Michigan, for Appellant. Kenneth W. Rosenberg, Kenneth L. Greene (briefed), U.S. Department of Justice, Appellate Section, Tax Division, Washington, D.C., for Appellee.

Before: MERRITT and SILER, Circuit Judges; BECKWITH, District Judge.*

OPINION

MERRITT, Circuit Judge. The question on appeal concerns the federal income taxation of clients on contingent fees paid to lawyers. In June 1988, a jury awarded Arthur Clarks $5,600,000 in personal injury damages against K-Mart for head injuries sustained while unloading his truck. In 1991, K-Mart paid $11,307,875.55 in total satisfaction of the judgment, $5,600,000 for the award and $5,707,837.55 in interest. From that amount, the judgment debtor paid Clarks' lawyer under a one-third, contingent fee contract $1,865,156.54 based on the original award and $1,901,314.67 based on the interest for a total fee of $3,766,471.21. After Clarks died in March 1992, his estate

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*The Honorable Sandra S. Beckwith, United States District Judge for the Southern District of Ohio, sitting by designation.

filed his 1040 for the 1991 tax year. Recovery for personal injury is ordinarily not taxable under § 104(a)(2) of the Internal Revenue Code, but the interest on the award is. The only question before us on appeal is whether the $1,901,314.67 in interest paid to the lawyer must be included as gross income of the decedent under § 61(a) of the tax code ("gross income means all income from whatever source derived"), as well as included in the lawyer's income. The estate did not include the interest portion of the attorney fee award as interest income because the estate did not receive any of the money. It was paid directly to the lawyer.

In November 1992, the IRS conducted an audit of Clarks' 1991 tax return. It notified the decedent's estate that it had a tax deficiency of $254,298 because the estate improperly failed to include as income the interest paid to the lawyer on the contingent fee contract and because the interest should be deducted as a miscellaneous itemized deduction subject to a two percent of adjusted gross income limitation. *See* 26 U.S.C. §§ 61(a), 67(a). As a result of the two percent floor on itemized deductions under Code § 67(a) ("miscellaneous itemized deductions . . . allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income") and the alternative minimum tax applicable to interest income under Code § 55, the estate had to pay the additional $254,298 in taxes owed, plus interest. The estate filed an action in federal district court seeking a refund of all tax and interest paid on the interest portion of the damage award for the 1991 tax year. At no time has the non-interest portion of the award ($5,600,000) been at issue since it is clearly not taxable as income pursuant to

26 U.S.C. § 104(a)(2). Neither is there an issue before us concerning the taxation of the income in the hands of the lawyer. Both parties filed cross motions for summary judgment. The district court granted summary judgment for the government and against the taxpayer. We do not agree.

* * *

There is a conflict in the Circuits on the issue of whether the interest portion of an attorney's contingency fee should be included in the client's income under Code § 61(a), even though the lawyer received and paid taxes on all of the money and the client received none of the money. Compare *Cotnam v. Comm'r*, [59-1 USTC ¶ 9200], 263 F.2d 119 (5th Cir. 1959), with *Baylin v. United States* [95-1 USTC ¶ 50,023], 43 F.3d 1451 (Fed. Cir. 1995). Cotnam was the first to address the issue. In a 2-1 decision, the old Fifth Circuit held that the amount of the contingent fee paid out of the judgment to plaintiff's attorneys was not income to plaintiff. *See Cotnam* [59-1 USTC ¶ 9200], 263 F.2d at 126. Under Alabama state law, a contingency fee contract operates as a lien on the recovery. The Alabama code provided at the time that "attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them." 46 Ala.Code § 64 (1940). The Cotnam court found that this lien operated as a transfer of part of plaintiff's claim and that any recovery as to that portion of the claim would not be regarded as gross income to the plaintiff taxpayer. *Cotnam* [59-1 USTC ¶ 9200], 263 F.2d at 125. The court concluded that the amount of the contingent fee was earned by the attorney, not the taxpayer, whose only real

economic benefit from the claim amounted to a percent of the total judgment he received due to the lawyer's efforts. *See id.* at 126.

The common law lien in this case under Michigan law operates in more or less the same way as the Alabama lien in Cotnam. RAY ANDREWS BROWN, THE LAW OF PERSONAL PROPERTY § 116, at 559 (2d ed. 1955), describes a common law attorney's lien as follows:

> According to Mr. Justice Earl, of the New York Court of Appeals, "the lien, as thus established, is not strictly like any other lien known to the law, because it may exist although the attorney has not and cannot, in any proper senses, have possession of the judgment recovered. It is a peculiar lien, to be enforced by peculiar methods. It was a device invented by the courts for the protection of attorneys against the knavery of their clients, by disabling clients from receiving the fruits of recoveries without paying for the valuable services by which the recoveries were obtained. The lien was never enforced like other liens. If the fund recovered was in possession or under the control of the court, it would not allow the client to obtain it until he had paid his attorney, and in administering the fund it would see that the attorney was protected. If the thing recovered was in a judgment, and notice of the attorney's claim had been given, the court would not allow the judgment to be paid to the prejudice of the attorney." [Quoting Goodrich v. McDonald, 112 N.Y. 157, 19 N.E. 649 (1889)].

Although the underlying claim for personal injury was originally owned by the client, the client lost his right to receive payment for the lawyer's portion of the judgment.

Michigan law is not inconsistent with this view of the attorney's lien, *Dreiband v. Candler*, 166 Mich. 49, 131 N.W. 129 (1911), – holding that "the [contingent fee] agreement amounts to an assignment of a portion of the judgment sought to be recovered." *Id.* at 51, 131 N.W. at 129.

In a more recent decision, the Federal Circuit reached the opposite result. Baylin held that the contingent fee portion of settlement from a condemnation proceeding paid directly to the lawyer was income to the plaintiff taxpayer. *Baylin* [95-1 USTC ¶ 50,023], 43 F.3d at 1455. Baylin mentioned the Supreme Court's liberal interpretation of "gross income" and then found that although the plaintiff never had actual possession of the funds paid to the lawyer, plaintiff received the benefit of those funds in that they discharged an obligation of the plaintiff owed to the lawyer as a result of his work. *See Baylin* [95-1 USTC ¶ 50,023], 43 F.3d at 1454.

Baylin relied on two early Supreme Court tax cases interpreting § 61(a), *Lucas v. Earl* [2 USTC ¶ 496], 281 U.S. 111 (1930) and *Helvering v. Horst* [40-2 USTC ¶ 9787], 311 U.S. 112 (1940). In Lucas, taxpayer Earl assigned one half his right to salary and fees earned by him to his wife in order to avoid paying taxes on the whole, *Lucas* [2 USTC ¶ 496], 281 U.S. at 113-14. In *Horst*, taxpayer Horst, the owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son who later that year collected interest on them. *Horst* [40-2 USTC ¶ 9787], 311 U.S. at 114. Even though the proceeds were originally vested in the donors, since Lucas himself never received the income apportioned to his wife and Horst never actually received any interest from the coupons, both

claimed that they should not have to include the assignment as income. In rejecting the taxpayer's argument, the Supreme Court concluded that the "dominant purpose of the revenues laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid." *Horst* [40-2 USTC ¶ 9787], 311 U.S. at 119. In Lucas and Horst, each taxpayer earned and created the right to receive and enjoy the benefit of the income before any assignment.

We follow Cotnam concluding that the majority in Cotnam correctly distinguished *Lucas v. Earl* [2 USTC ¶ 496], 281 U.S. 111 (1930), and *Helvering v. Horst* [40-2 USTC ¶ 9787], 311 U.S. 112 (1940). In the instant case, as in Cotnam, the value of taxpayer's lawsuit was entirely speculative and dependent on the services of counsel. The claim simply amounted to an intangible, contingent expectancy. The only economic benefit Clarks could derive from his claim against the defendant in state court was to use the contingent part of it to help him collect the remainder. Like an interest in a partnership agreement or joint venture, Clarks contracted for services and assigned his lawyer a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds. Just as in Cotnam, the assignment Clarks' lawyer received operated as a lien on a portion of the judgment sought to be recovered transferring ownership of that portion of the judgment to the attorney.

In Lucas and Horst, the income assigned to the assignee was already earned, vested and relatively certain to be paid to the assignor. It was a gift of accrued income to a family member. The assignor's purpose was to split income with a family member and avoid the

donor's higher rate under the progressive income tax. The income had a tangible known value to the assignor. The assignee performed no services in order to receive the income. There was no business purpose other than tax avoidance. There was no joint venture to reduce a speculative claim to money. Not so in this case. Here there was no res, no fund, no proceeds, no vested interest, only a hope to receive money from the lawyer's efforts and the client's right, a right yet to be determined by judge and jury. Clarks, as an assignor, had no predetermined interest in any res before entering a contingency fee arrangement with his attorney, unlike the taxpayer plaintiffs in Lucas and Horst. There was no purpose to shift tax liability among members of a family.

In Lucas and Horst, the assignees were the object of gifts and not subject to income taxation themselves if the income was taxed to their assignor or donor. The IRS chose to tax the assignors, not both the donors and donees. By having the income taxed to the donor, the donee escapes income taxation. Not so here. Here the lawyer is taxed on the full amount of the payment. Under the government's theory both the lawyer and the client are taxable.

The present transaction under scrutiny is more like a division of property than an assignment of income. Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. Here the lawyer's income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his

income to avoid taxation. The income should be charged to the one who earned it and received it, not as under the government's theory of the case, to one who neither received it nor earned it. The situation is no different from the transfer of a one-third interest in real estate that is thereafter leased to a tenant. *See Wodehouse v. Comm'r* [49-2 USTC ¶ 9474], 177 F.2d 881, 884 (2d Cir. 1949); Surrey, "Assignments of Income and Related Devices, Choice of the Taxable Person," 33 Col. L. Rev. 791 (1933).

For the forgoing reasons, we reverse the judgment of the district court and grant plaintiff estate's motion for summary judgment.

T.C. Memo. 1998-291

UNITED STATES TAX COURT

FRANKLIN P. AND NONA COADY, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 4722-97. Filed August 6, 1998.

Lance A. Hulbert, for petitioners.

Gregory M. Hahn, for respondent.

MEMORANDUM OPINION

LARO, *Judge*: This case is before the Court fully stipulated. See Rule 122. Franklin P. and Nona Coady petitioned the Court to redetermine respondent's determination of a $49,531 deficiency in their 1994 Federal income tax. Following concessions, we must decide whether petitioners' 1994 gross income includes $373,307 that was awarded to Ms. Coady as compensation for a wrongful termination, or a lesser amount that is net of the legal fees and other costs that she incurred to recover this award. We hold it is the greater amount. Unless otherwise stated, section references are to the Internal Revenue Code in effect for the year in issue. Rule references are to the Tax Court Rules of Practice and Procedure. Dollar amounts are rounded to the nearest dollar.

Background

All facts have been stipulated.[1] The stipulated facts and the exhibits submitted therewith are incorporated herein by this reference. When petitioners petitioned the Court, they resided in Lake Havasu City, Arizona. They are husband and wife, and they filed a 1994 Form 1040, U.S. Individual Income Tax Return, using the filing status of "Married filing joint return".

On May 5, 1990, Ms. Coady was discharged from her employment with Alaska Housing Finance Corporation (AHFC). Thereafter, while she resided in Alaska, she retained an attorney in the Alaska office of the law firm of Hellen, Partnow & Condon (HPC) to represent her in a wrongful termination suit against AHFC. According to the terms of that representation:

> [Ms. Coady is] responsible for all costs incurred, e.g. filing fees, long distance telephone calls, telefax transmissions, photocopies, deposition charges, witness fees, computer research fees, appraiser's fees, travel expenses for attorneys or witnesses, expert consultation charges, cost of the investigation.
>
> Attorney time will be compensated on the basis of the following contingent fee schedule:
>
> 33-1/3% if recovery is arrived at without appeal of any judgment.

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[1] Petitioners ask the Court to find a fact from a letter that they attached to their posttrial brief. We decline to do so. This letter is not evidence. Rule 143(b); see also *Boyd Gaming Corp. v. Commissioner*, T.C. Memo. 1997-445.

45% in the event that any judgment is appealed and representation continues after a notice of appeal is filed.

On or about April 13, 1991, HPC, on behalf of Ms. Coady, filed suit against AHFC and certain individuals in the Superior Court for the State of Alaska, alleging damages arising from a wrongful termination of Ms. Coady's employment. Following a non-jury trial, the court held AHFC, but not the individuals, liable for Ms. Coady's wrongful termination and awarded her the following damages:

Lost past earnings	$ 89,225
Lost future earnings	76,980
Lost fringes and lost pension	207,102
Total	373,307

AHFC paid Ms. Coady the awarded damages on November 7, 1994, issuing her a check for $259,611 and withholding $113,696 for Federal and State taxes. In the same year, Ms. Coady paid HPC legal fees and litigation costs totaling $221,338; of this amount, $124,436 represented HPC's contingent fee (33-1/3% x $373,307) and $96,903 represented litigation costs, AHFC issued Ms. Coady a 1994 Form W-2, Wage and Tax Statement, reporting that it paid her the $373,307 award as "wages, tips, other compensation."

On their 1994 Form 1040, petitioners included the $373,307 award in wages, and claimed a $284,082 "above-the-line" deduction for the amount of the award that was not paid on account of past earnings. Petitioners claimed and reported on their return that the $284,082 was received by Ms. Coady as self-employment income, and they claimed that $168,217 of the legal fees and costs was

deductible from this income, resulting in net income from self-employment of $115,865.[2] Petitioners claimed a miscellaneous itemized deduction of $53,121 with respect to the remaining legal fees and costs.

Respondent determined, and reflected in a notice of deficiency issued to petitioners on December 10, 1996, that petitioners' 1994 gross income includes the total award of $373,307. Respondent also determined that petitioners' legal fees and costs totaling $221,338 were deductible as a miscellaneous itemized deduction subject to the 2-percent floor under section 67. Petitioners concede that none of the award, legal fees, or costs was attributable to self-employment.

Discussion

Petitioners argue that their 1994 gross income does not include the entire $373,307 award. According to petitioners, $221,338 of the award is excluded from their gross income because it was paid to Ms. Coady's counsel, HPC, under the contingent fee agreement. Petitioners rely on *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), revg. in part and affg. in part 28 T.C. 947, 1957.[3] In the Cotnam case, the taxpayer had entered into a contingent fee agreement with her attorneys, under which the taxpayer agreed to pay the attorneys 40 percent of any

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[2] Petitioners' allocation to self-employment of legal fees and costs bears the same ratio (as rounded) as petitioners' allocation to self-employment of the award; i.e., $168,217/$221,338 = $284,082/$373,307.

[3] See also *Davis v. Commissioner*, T.C. Memo. 1998-248 (following *Cotnam* as to the law of the circuit).

amount recovered on a claim that they prosecuted on her behalf. The taxpayer received a judgment on the claim, and a check in the amount of the judgment was made payable to both her and her attorneys. The attorneys retained their share of the proceeds, and they remitted the rest to the taxpayer. In holding that the amount retained by the attorneys was not includable in the taxpayer's gross income, the Court of Appeals for the Fifth Circuit concluded that, under applicable State (Alabama) law, the contingent fee agreement operated to assign to the attorneys an equitable lien and interest as to 40 percent of the judgment. As stated in the provision of the Alabama Code relied upon by the Court of Appeals to reach its conclusion:

> 2. Upon suits, judgments, and decrees for money, * * * [attorneys] shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said suit, judgment or decree, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them. [*Id.* at 125 n. 5 (quoting 46 Ala. Code sec. 64 (1940); quotation marks omitted).]

We disagree with petitioners that *Cotnam v. Commissioner, supra,* controls the Court's decision herein. In our case, the relevant section 34-35-430 of the Alaska Code, i.e., the statute that is applicable here, provides as follows:

> Sec. 34-35-430. Attorney's lien. (a) An attorney has a lien for compensation, whether specially agreed upon or implied, as provided in this section
>
> (1) first, upon the papers of the client that have come into the possession of the attorney in the course of the professional employment;
>
> (2) second, upon money in the possession of the attorney belonging to the client;
>
> (3) third, upon money in the possession of the adverse party in an action or proceeding in which the attorney is employed, from the giving of notice of the lien to that party;
>
> (4) fourth, upon a judgment to the extent of the costs included in the judgment or, if there is a special agreement, to the extent of the compensation specially agreed on, from the giving of notice of the lien to the party against whom the judgment is given and filing the original with the clerk where the judgment is entered and docketed.
>
> (b) This lien is, however, subordinate to the rights existing between the parties to the action or proceeding. [Alaska Stat. sec. 34-35-430 (Michie 1996).]

This provision stands in marked contrast to the provision of the Alabama Code relied upon by the Court of Appeals for the Fifth Circuit in the *Cotnam* case. Although both provisions give an attorney a lien to secure his or her compensation, the Alaska provision, unlike the Alabama provision, does not give attorneys the same right and power over suits, judgments, and decrees as their clients had or may have. In contrast to a client subject to the

Alabama provision, a client subject to the Alaska provision retains all proprietary rights in his or her claim, subject to a statutory lien held by the attorney on any proceeds from the claim. See, e.g., *Hagans, Brown & Gibbs v. First Natl. Bank*, 783 P.2d 1164, 1168 (Alaska 1989) ("the claim belongs to the client and not to the attorney; the client has a right to compromise or even abandon his claim if he sees fit to do so"); see also *Phillips v. Jones*, 355 P.2d 166, 171 (Alaska 1960) (intent of Alaska attorney lien provision is to give attorneys security for their efforts through a lien on the subject of the action). The Alaska provision also subordinates an attorney's lien "to the rights existing between the parties to the action or proceeding", whereas the lien of an attorney under the Alabama provision is "superior to all liens but tax liens". In fact, the Alaska provision is similar to provisions of the Nebraska and South Dakota Codes, which we held in *Petersen v. Commissioner*, 38 T.C. 137, 151-152, 1962 WL 1067 (1962), were distinguishable from the provisions of the Alabama Code considered by the Court of Appeals for the Fifth Circuit in *Cotnam v. Commissioner, supra*.[4] See

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[4] The Nebraska provision as set forth in *Petersen v. Commissioner*, 38 T.C. 137, 152 n. 9, 1962 WL 1067 (1962), provided:

> *§ 7-108. Attorney's liens.* An attorney has a lien for a general balance of compensation upon any papers of his client which have come into his possession in the course of his professional employment; and upon money in his hands belonging to his client, and in the hands of the adverse party in an action or proceeding in which the attorney was employed from the time of giving notice of the lien to that party.

The South Dakota provision was similar to the Nebraska provision. *Id.*

also *Baylin v. United States*, 43 F.3d 1451, 1455 (Fed. Cir. 1995) (Maryland attorney lien statute does not give attorney an ownership interest in claim of his or her client); *Estate of Gadlow v. Commissioner*, 50 T.C. 975, 979-980, 1968 WL 1536 (1968) (Pennsylvania law distinguishable from Alabama statute applied in *Cotnam*).

We hold that Ms. Coady's award, undiminished by the amount that she paid her attorneys, is includable in petitioners' 1994 gross income under the principle of *Lucas v. Earl*, 281 U.S. 111 (1930).[5] Accord *Estate of Gadlow v. Commissioner, supra* at 979-980; *Petersen v. Commissioner, supra* at 151-152; *Hardin v. Commissioner*, T.C. Memo. 1997-202; *Martinez v. Commissioner*, T.C. Memo. 1997-126; *Alexander v. Commissioner*, T.C. Memo. 1995-51, affd. 72 F.3d 938, 946-947 (1st Cir.1995). We have considered all arguments by petitioners for a contrary holding, and, to the extent not mentioned above, find them to be without merit. To reflect concessions by respondent,

Decision will be entered under Rule 155.

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[5] We reject petitioners' claim that this principle is inapplicable because Ms. Coady's claim was "contingent" or "uncertain". The cases cited by petitioners to support that claim are distinguishable on their facts.